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COMMONWEALTH OF VIRGINIA

STATE CORPORATION COMMISSION

AT RICHMOND, AUGUST 6, 1998

APPLICATION OF

WASHINGTON GAS LIGHT COMPANY,
VIRGINIA DIVISION

CASE NO. PUE970328

For an Annual Informational Filing

FINAL ORDER

On March 31, 1997, Washington Gas Light Company, Virginia Division ("WGL" or "the Company") filed its Annual Informational Filing ("AIF") with the State Corporation Commission ("Commission"), together with financial and operating data for the twelve months ending December 31, 1996.

On August 1, 1997, the Commission Staff filed its report in this case. The report noted that after employing an earnings test based on actual test year jurisdictional earnings, average rate base, an average capital structure, and after making limited adjustments, WGL earned in excess of its authorized return on equity range of 11.0% - 12.0%. In order to mitigate WGL's overearnings position, Staff recommended that the Company be required to write off the Virginia jurisdictional portion of unamortized losses on reacquired debt, which Staff considered to be regulatory assets subject to an earnings test. The Staff

also proposed that WGL be required to file an earnings test if it sought to establish any new regulatory asset on its books. Further, the Staff recommended that WGL file an earnings test with its next AIF or rate application if the Company had any regulatory assets on its books at that time. Additionally, Staff proposed that WGL be required to track various components of off-system sales, effective January 1, 1997, including system capacity and any demand utilized to facilitate off-system sales. Finally, the Staff recommended that the Commission direct the Company to revise the actual cost adjustment ("ACA") language in its tariff as part of WGL's next rate application to allow proper crediting of off-system revenues and expenses.

On August 29, 1997, the Company, by counsel, filed a motion wherein it stated that it disagreed with Staff's application of the earnings test and Staff's recommendation that WGL write off regulatory assets related to unamortized losses on reacquired debt. WGL requested a hearing on these issues.

By Order dated September 8, 1997, the Commission assigned a Hearing Examiner to the matter, established a procedural schedule, and set the matter for hearing on October 16, 1997.

The matter was timely heard, and WGL and the Staff filed simultaneous briefs on December 12, 1997, in the proceeding.

The Chief Hearing Examiner issued her report on June 25, 1998. Based upon the evidence received, the Hearing Examiner

found that (i) losses on reacquired debt should be subject to an earnings test; (ii) application of an earnings test in this case does not constitute retroactive ratemaking or confiscation of shareholders' earnings; (iii) Staff's application of the earnings test is not prohibited by the Commission's Rules Governing Utility Rate Increase Applications and Annual Informational Filings or the Company's prior case, Case No. PUE940031; (iv) only adjustments necessary to restate actual data to a regulatory basis should be made in an earnings test; (v) previously approved regulatory assets should be considered recovered only through excess earnings above the top of the range unless otherwise provided for at the inception of a regulatory asset; and (vi) the Virginia jurisdictional level of unamortized losses on two debt issues reacquired during the test year should be written off in their entirety. The Chief Hearing Examiner recommended that the Commission enter an order that adopts the findings in her report, directs the Company to write off losses on reacquired debt incurred in the test period; and dismisses the case from the Commission's docket of active proceedings.

Comments on the Chief Hearing Examiner's Report were filed by WGL and the Staff.

Having considered the record, the Hearing Examiner's Report, and the Comments thereto, the Commission is of the

opinion and finds that losses on reacquired debt refunded with long-term debt, although booked as a regulatory asset, should not be subject to the earnings test for the reasons set forth below. We also find that losses on reacquired debt without refunding may be different in character than losses on reacquired debt with refunding and that the question of whether such losses should be subject to the earnings test should be examined in future cases.

We further find that WGL should comply with the other recommendations set out in the August 1, 1997 Staff Report that the Company did not challenge. In this regard the Company should track the various components of off-system sales, effective January 1, 1997, including system capacity and demand utilized to facilitate off-system sales; should revise its ACA tariff language to permit the proper crediting of any off-system revenues and expenses; and should file an earnings test with the establishment of any regulatory asset other than losses on reacquired debt with refunding.¹

A regulatory asset is a deferral of a current period cost amortized over future periods. Such costs are generally large

¹ The Company should also file an earnings test with its next AIF and rate application if the Company has any regulatory assets other than losses on reacquired debt refunded with long-term debt on its books at that time. The Company should refer to the Final Order in Application of Roanoke Gas Company, For an Annual Informational Filing, Case No. PUE960102, and Application of Roanoke Gas Company, For expedited rate relief, Case No. PUE960304, entered today, for guidance on the preparation of an earnings test.

and nonrecurring and cause financial results to be negatively affected when currently expensed. This deferred treatment of current charges is unique to regulated entities. Unregulated entities under Generally Accepted Accounting Principles would expense the charges in the period incurred. By permitting a regulated public utility to defer these charges, the utility is afforded an opportunity to recover them over future periods. A utility's shareholders benefit from the original deferral of charges associated with regulatory assets because the deferral increases earnings above what they would have been had there been no deferral.

An earnings test has been used to determine whether regulatory assets have been recovered more quickly than anticipated or whether they should continue to be deferred and amortized. The earnings test has been employed in other cases to evaluate the test period recovery of a number of regulatory assets, including other post employment benefits ("OPEB") implementation costs, electric capacity contract charges, and extraordinary storm damage costs. In the Final Order entered today in Application of Roanoke Gas Company, For an Annual Informational Filing, Case No. PUE960102 and Application of Roanoke Gas Company, For expedited rate relief, Case No. PUE960304, we applied an earnings test to evaluate recovery of rate case expenses, costs of a depreciation study, franchise

costs, Liquefied Natural Gas ("LNG") tank painting costs, union contract negotiation costs, and demolition costs related to a retired manufacturing gas plant. None of these cases involves whether losses on reacquired debt should be subject to an earnings test.

In this case, the Staff seeks to apply the earnings test to losses on reacquired debt. A loss on reacquired debt is an accounting classification for several types of expenses associated with the retirement, or reacquisition, of debt securities prior to their maturity. When debt is reacquired early, the original accounting for any remaining unamortized expenses on the reacquired debt is changed to reflect the fact that the debt is no longer outstanding. Early retirement of debt may also result in a prepayment penalty, i.e., a call premium. Upon early retirement of a debt issue, a call premium plus any remaining unamortized expenses are classified together as a loss on reacquired debt.²

The threshold issue presented by this case is whether losses on reacquired debt should be subject to the earnings test. We conclude that they should not if the debt is refunded with long-term debt. These regulatory assets differ in significant respects from those which we have required utilities

² Staff, in its discussion, combined debt discounts and premiums with expenses related to underwriting activities, legal counsel, printing, and obtaining a rating, among other things. In Virginia, these types of expenses are amortized over the remaining life of the reacquired debt issue or, in the case of a refunding, the life of the new debt issue.

to write off in other proceedings. WGL's losses on reacquired debt with refunding have been amortized over the life of the refunding debt for a finite identifiable period. These losses on reacquired debt are explicitly tied to a refinancing where the loss is intentionally incurred in order to produce savings in the form of lower interest costs over an identifiable period of time.

In Virginia, we amortize losses on reacquired debt over the life of the refunding debt and consider them to be a cost of issuing the new debt, much like any other type of debt issuance expense. This treatment is appropriate, and losses on reacquired debt, like other expenses of the refunding debt, should not be subject to the earnings test.

While we have determined that losses on reacquired debt with refunding should not be subject to an earnings test, we find that losses on reacquired debt without refunding with long-term debt may be subject to the test. As explained below, however, we will not require the write-off of WGL's losses on reacquired debt without refunding in this case.

As a result of the reacquisition of a series of bonds without refunding, the Company incurred a net gain. For ratemaking purposes, the Commission has historically amortized gains, net of losses, over the life of the retired series. The netting of the gain with the loss ensures that those paying the

loss also receive the associated gains. In this case, given this prior treatment, we will not subject WGL's existing losses on reacquired debt without refunding to the earnings test. However, we direct that losses on reacquired debt without refunding be examined on a case-by-case basis to determine if they are in fact different from other regulatory assets or whether both gains and losses should be written off in the year they are incurred.

Accordingly, IT IS ORDERED THAT:

(1) WGL's losses on reacquired debt shall not be subject to an earnings test in this case and therefore need not be written off.

(2) WGL shall file an earnings test with the Commission if it seeks to establish any new regulatory assets with the exception of losses on reacquired debt refunded with long-term debt.

(3) WGL shall file an earnings test as provided herein with its next AIF or rate application if the Company has on its books at that time any regulatory assets other than losses on reacquired debt refunded with long-term debt.

(4) WGL shall be required to track the various components of off-system sales, effective January 1, 1997, including system capacity and any demand utilized to facilitate off-system sales.

(5) WGL shall revise the language in its tariffs addressing its ACA as part of its next rate application to allow proper crediting of off-system revenues and expenses.

(6) There being nothing further to be done herein, this matter shall be dismissed from the Commission's docket of active proceedings, and the papers filed herein made a part of the Commission's files for ended causes.